Internal Revenue Service
memorandum

date: MAR 19

to: Sharon Katz-Pearlman, Special Litigation Assistant
Office of District Counsel - Manhattan

from: Christine Halphen, CH Special Assistant to the ACC(I) CC:INTL

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subject: Determination of withholding on adjustments made pursuant to section 482

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This is in response to your request for technical assistance dated January 23, 1990, regarding the imposition of a withholding tax under section 1442 of the Code in the event certain transfer pricing adjustments result in constructive dividends to a foreign parent corporation.

As stated in your letter, the facts involve [redacted] related domestic corporations to which transfer pricing adjustments are being proposed under section 482 to reflect an arm's length price for goods purchased by those corporations from their foreign parent. The proposed adjustments will consist of reductions in the prices charged on intercompany sales. The foreign parent is located in a country that has an income tax treaty with the U.S. The domestic corporations file on a fiscal year basis, and the statute of limitations with respect to their Chapter 1 tax liability for the years under examination [redacted] expires on [redacted]. You are uncertain as to whether any of the domestic corporations have filed any IRS Form 1042 or 1042S for the period under examination.

The issues you have asked us to address are as follows:

1. Whether it is correct, as a collateral effect of the proposed pricing adjustments, to treat the price overcharges as constructive dividends from the U.S. subsidiaries to the foreign parent, creating a withholding tax liability to the U.S. subsidiaries under section 1442.

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2. Whether any relief is available to the U.S. subsidiaries and their foreign parent.

3. How to calculate the withholding tax liability given the fact that the U.S. subsidiaries use a fiscal year whereas the withholding tax liability is determined on a calendar year basis.

4. Statute of limitations issues, including whether and how the expiration of the U.S. subsidiaries' statute of limitations on 6/30 affects the assessment of any section 1442 tax.

Issue 1: Whether it is correct, as a collateral effect of the proposed pricing adjustments, to treat the amounts paid by the U.S. subsidiaries over the arm's length amounts as constructive dividends from them to their foreign parent, creating a withholding tax liability under section 1442.

It is well settled law that, where property is transferred from a subsidiary to its parent corporation in a purported business arrangement (such as the sale of goods) which is not at arm's length so that an allocation results under section 482, the property transferred in excess of the arm's length amount is treated as a constructive dividend to the parent corporation. See Nissho Iwai American Corp. v. Commissioner, 50 TCM 1483 (1985).

Under sections 301 and 316, the amount of the dividend is limited to the amount of the subsidiary's current and accumulated earnings and profits, as recalculated taking into account the section 482 adjustment. The constructive dividend is subject to withholding tax under section 1442 at a 30 percent tax rate, unless the rate is reduced under an applicable income tax treaty. Constructive dividends also give rise to a liability of the foreign parent corporation under section 881(a), which may be asserted against the foreign corporation. However, the tax can be collected only once, i.e., from the withholding agent under section 1442 (the U.S. subsidiary that was overcharged on its purchases from its foreign parent) or from the foreign parent under section 881. See section 1463 and section 1.1463-1.

Issue 2: Whether any relief is available to the domestic corporations.

While the IRS may assert constructive dividends and impose a withholding tax, the taxpayer may be entitled to relief under

Rev. Proc. 65-17, 1965-1 C.B. 883. Rev. Proc. 65-17 relief was extended to inbound transfer pricing cases under Rev. Rul. 82-80, 1982-1 C.B. 89. The ruling deals with the foreign parent of a domestic subsidiary whose taxable income is increased as a result of an allocation under section 482. The ruling provides, in part, that:

> [I]f Rev. Proc. 65-17 treatment is granted, the original transaction will be treated, for tax purposes, as if the correct amount, as determined under section 482 of the Code, was paid. For example, if a United States subsidiary pays more than arm's length consideration for services performed by its foreign parent corporation, the parent corporation will not be considered to have received a dividend to the extent of the greater-than-arm's-length amount, and the withholding tax provisions of section 881 and 1442 will not be applied.

Rev. Proc. 65-17, as amplified by Rev. Proc. 65-31, 1965-2 C.B. 1024, as amended by Rev. Proc. 65-17, Amendment I, 1965-2 C.B. 1211, amplified and clarified by Rev. Proc. 70-23, 1970-2 C.B. 505, and amplified by Rev. Proc. 71-35, 1971-2 C.B. 573, sets forth the procedures for relief from certain collateral effects of an allocation under section 482. In particular, a U.S. taxpayer, whose taxable income has been increased for a taxable year by reason of an allocation of income under section 482, may request permission to receive payments from the entity from which the allocation of income was made of an amount equal to a part or all of the amount allocated, without further Federal income tax consequences.

At the time it was issued, this procedure was designed primarily for outbound cases, where, typically, a U.S. parent would undercharge for goods or services sold or rendered to its foreign subsidiary. Where the U.S. parent's income is increased as a result of an allocation under section 482, Rev. Proc. 65-17 allows the parties to, in effect, have the cash follow the income without tax consequences. Thus, if in order to reflect the allocation, the parent receives a payment from its subsidiary, this payment would not be treated as a taxable dividend under Rev. Proc. 65-17 (nor would a section 902 foreign tax credit be allowed). The fiction is that the extra cash held by the foreign subsidiary because of the non-arm's length dealings results from a loan of funds from its U.S. parent. Thus, the repayment of those funds will be treated as a non taxable repayment of a loan. The condition for this treatment, however, is that, as part of a closing agreement with the District Director, the U.S. parent agree to set up an interest-bearing account receivable from its foreign subsidiary. The account must be equal to the amount of the section 482 adjustment, reduced by any offset allowed to the taxpayer under Rev. Proc. 64-54, and increased by the amount of interest deemed to have accrued on such account receivable since the last day of the taxable year with respect to which the allocation is made.

Relief under Rev. Proc. 65-17 is available only if the Service determines that the transactions giving rise to the allocation did not have as one of their principal purposes the avoidance of Federal income tax.

In an inbound case where the income allocation results from the subsidiary having overpaid for goods or services, it appears that a similar loan fiction is intended, even though it is not articulated in that fashion in Rev. Proc. 65-17 nor clarified in Rev. Rul. 82-80, making Rev. Proc. 65-17 available to inbound situations. See G.C.M.38676 (April 6, 1981), that proposed an earlier version of Rev. Rul. 82-80. In that case, it seems that the amounts treated as overcharges would be deemed loans by the U.S. subsidiary to its foreign parent.

In conclusion, in the event any U.S. subsidiary requests and qualifies for relief under Rev. Proc. 65-17, and provided the U.S. subsidiary agrees to set up an interest-bearing account receivable and to recognize interest income at the rates provided in Rev. Proc. 65-17, such U.S. subsidiary's payments in excess of an arm's length charge would not be treated as dividend payments, and the repayment of the account receivable would have no more U.S. tax consequences than the repayment of a loan.

No relief should be granted if no requests are made or if the conditions for relief set forth in Rev. Proc. 65-17 are not satisfied. The issue should be raised, and an adjustment proposed, even though there is a good probability that it would be settled in the course of competent authority proceedings, if this remedy is sought.

Issue 3: How to calculate the withholding tax liability given the fact that the U.S. subsidiaries use a fiscal year whereas the withholding tax liability is determined on a calendar year basis.

Assuming the U.S. subsidiaries do not request relief under Rev. Proc. 65-17 or do not qualify for such relief, then the withholding tax liability must be calculated.

To be subject to withholding, a distribution must qualify as a dividend under section 301 and 316. Thus, it must be a distribution of "property" out of "earnings and profits." Consistent with this rule, section 1.1441-3(b)(1) of the regulations provide that a withholding tax is due on the gross amount of any distribution made by a corporation, other than a nontaxable stock dividend or a distribution which is treated in part or in full payment in exchange for the stock (i.e., in excess of the corporation's earnings and profits). However, to deal with distributions in the course of the year when it is not yet determined whether the distributions will be out of E&Ps, Rev. Rul. 72-87, 1972-1 C.B. 274 provides that all distributions made in the ordinary course of business are subject to withholding even though some or all of such distributions may eventually be treated as gains from the sale or exchange of property. Refund procedures are available if it is subsequently determined that no tax was due.

Under your facts where years [redacted] and [redacted] are under examination, it would be easy to determine the withholding tax due for tax years [redacted] and [redacted] (based on E&Ps of the U.S. subsidiaries, as recalculated for each of those years). However, as you point out, the examination covers only 3 months of the [redacted] calendar year. Based on Rev. Rul. 72-87, it appears that a withholding tax can be imposed on the amounts treated as distributions attributable to those 3 months of [redacted]. If, as a result of a subsequent examination of the [redacted] tax year, it turns out that those distributions were not dividends, then an adjustment can be made at this time.

Issue 4: Statute of limitations issues

The tax imposed on a withholding agent under section 1442 is an assessable tax separate from the tax imposed on such agent under Chapter 1. Each tax is subject to separate filing and payment requirements. See section 1.1461-2 and 1.1461-3. Thus, the statute of limitations runs independently and separately with respect to each tax. Section 6501(b)2) dealing with limitations on assessments and collection provides special rules for taxes imposed under Chapter 3 (i.e., sections 1441 and 1442), indicating that Chapter 3 taxes are intended to be covered under their own statute of limitations. Consequently, if the U.S. subsidiaries did not file Forms 1042 for years [redacted], [redacted] or [redacted], then the withholding tax may be assessed at any time.

If, however, any of the U.S. subsidiaries filed a Form 1042 for any of those years with respect to any item of FDAP income, then the statute of limitations would expire 3 years from the date a Form 1042 was filed, or, in the case of a timely filed return, 3 years from April 15 of the year succeeding the calendar year with respect to which the form was filed. Section 6501(b)(2).

It appears that the items subject to withholding tax and required to be reported on Form 1042 are aggregated on an annual basis. Therefore, the statute of limitations does not run separately with respect to each item of FDAP, but, rather, with respect to the entire Form 1042 itself. This seems to be the result even though the withholding agent is required to attach a Form 1042S to the Form 1042 for each different payee. This is because the Form 1042S is merely an information return, apparently not relevant for purposes of the limitations rules of section 6501.

As is the case for most income taxes imposed under Subtitle A, an assessment of withholding tax is accomplished by issuing a notice of deficiency and the deficiency must be calculated for the entire year to which the notice applies. If the taxpayer is mailed a notice of deficiency on account of the withholding tax for calendar tax year [redacted], no additional deficiency of income tax may be assessed for the same taxable year after a petition is filed in the Tax Court. Section 6212(c)(1). Therefore, it is important to determine the deficiency amount as correctly as possible, without being "arbitrary and capricious." The difficulty, in your case, is that you do not know how much withholding tax to set up for calendar year [redacted] since the examination of the [redacted] tax year has not begun. Under the circumstances, we have concluded that it would be reasonable to estimate the withholding tax deficiency for [redacted] by extrapolating the income allocation adjustments proposed for the prior years and making a reasonable estimate of the income allocation for year [redacted].

Note that, if the amounts determined to be constructive dividends exceed 25 percent of the total amount of FDAP items reported on the Form 1042 for the applicable year, you may also be able to argue that the special six-year statute of limitations applies rather than the three-year statute. Section 6501(e)(1) provides for a special six-year statute "If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income <u>stated in the return</u>" (emphasis added). There is some ambiguity, however, in the reading of section 6501(e)(1), suggesting that the gross income in question must be that of the taxpayer, rather than the type of income reportable on a Form 1042. Because of this uncertainty, we suggest that you issue a notice of deficiency using a reasonable estimate of the probable withholding tax liability for that year.

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